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Carlyle Hedge-Fund Unit Has Big Outflow

By Juliet Chung and Laurence Fletcher

Investors have pulled about $2.5 billion since October from a hedge-fund firm owned by Carlyle Group LP after an outsize bet on mortgage giants Fannie Mae and Freddie Mac led to steep losses last year, people familiar with the matter said.

The investment losses at Claren Road Asset Management LLC came as all three of the hedge-fund firms Carlyle bought majority stakes in over the past few years—including Emerging Sovereign Group LLC and Vermillion Asset Management LLC—suffered losses last year.

Carlyle is one of several buyout firms that has expanded into hedge funds in recent years as part of broader moves to diversify. Carlyle executives spoke broadly about the losses in an earnings call earlier this month and said they remain confident in their hedge-fund investments despite the difficult year. But they didn't provide specifics about the funds' performance or about continued client withdrawals this year.

Claren Road, which Carlyle bought in 2010 and which bets on and against debt, lost 9.9% last year in its first losing year, including a 9.7% loss in October. Claren Road investors asked for about $2 billion from the hedge-fund

firm last quarter and have submitted redemption requests of nearly a half-billion dollars this year, people familiar with the matter said.

Assets under management have shrunk from $8.5 billion in September to about $5.2 billion at the start of the year, a figure that accounts for the funds requested for redemption last quarter.

Most of Claren Road's losses stemmed from a soured investment in Fannie and Freddie. That position made up more than one-tenth of Claren Road's portfolio before an unfavorable court ruling in September sent the price of the stocks plunging and hurt a wide swath of hedge funds holding the stocks.

Claren Road—founded by Brian Riano, John Eckerson, Sean Fahey and Albert Marino —has since more than halved that position and instituted a policy limiting to 5% trades in noninvestment-grade securities, said people familiar with the firm. People close to Claren Road said the hedge fund annually updates its risk-management guidelines.

Hedge funds are attractive to private-equity firms in part because they can add billions of dollars in assets that are subject to management and performance fees. They also help these firms bring in and retain clients and smooth bumps in quarterly earnings caused by the uneven nature of the deals market.

Some efforts have stumbled. Fortress Investment Group LLC has reported losses in Fortress co-founder Michael Novogratz 's hedge fund both last year and this year and seen its macro business shrink since 2007, though it is expanding its hedge-fund presence in other areas. KKR & Co. last year shut down an internal hedge fund, citing lack of scale, even as it increases the stable of hedge-fund firms it buys stakes in and its fund-of-hedge funds business grows.

Carlyle said it continues to support its hedge funds, and people familiar with the firm said the funds as a whole have increased assets under management and

generated significant performance fees for Carlyle since the deals were struck.

“We continue to have confidence in our hedge-fund partnerships,” Carlyle co-founder William Conway said in the earnings call. “They performed very well over a long period of time but had a challenging year.”

Carlyle recruited Morgan Stanley veteran Mitch Petrick in 2010 to help the Washington-based firm diversify beyond leveraged buyouts. Under Mr. Petrick, the assets under management of Carlyle’s Global Market Strategies business, of which the hedge funds are a part, grew from $12 billion in 2009 to $34 billion last year. Distributable earnings, the portion of profit that can be paid to shareholders, went from a $1 million loss in 2009 to $690 million over the next five years, filings show.

Almost none of last year’s $91 million in distributable earnings from that business came from the hedge funds.

Claren Road’s performance has picked up. This year through Wednesday, Claren Road is up 1.4% in its flagship fund, said a person familiar with the matter; the fund’s annualized return is 6.8%. “We have a lot of confidence in” Claren Road, said Carlyle co-founder David Rubenstein in the earnings call.

Carlyle’s other hedge funds have struggled, too. ESG, a $5.2 billion emerging-markets fund, lost 7% in its flagship fund last year; its average annualized return is 10.5%. Vermillion, a roughly $1.5 billion commodities firm, lost money, too. Though its Aeris Metals fund gained 0.5% last year, its Viridian fund lost 15.3% in September alone, according to investor letters.

Carlyle’s founders and senior leadership personally invested in the funds, in addition to the firm’s money to fund the hedge-fund deals, said people familiar with the matter. It hasn’t ruled out continuing to buy into hedge funds and expects some volatility in its hedge funds’ performance, some of the people said.

The firm has had setbacks in its hedge-fund dealings before. In March 2007, Carlyle launched a hedge fund called Blue Wave as a joint venture with a pair of former Deutsche Bank AG executives. Blue Wave dove into residential mortgage-backed securities as the market was collapsing and lost 17% in 2007. Carlyle liquidated the fund the next year.

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